RD AN No. 3572 (4287-B)
September 28, 2000

SUBJECT: Business and Industry Guaranteed Loan Program
Lender Financial Analysis Requirements

TO: State Directors, Rural Development

ATTN: Business Programs Directors, Rural Development Managers, and Community Development Managers

PURPOSE/INTENDED OUTCOME:

The Office of Inspector General (OIG) has issued Audit Report No. 34601-0002-Ch, "Business and Industry (B&I) Guaranteed Loan Program Statement Analysis." The report states that lenders are not obtaining financial statements from borrowers as required under the lender agreements, and, in many instances, lenders are not properly analyzing the financial statements received in a manner that would reduce the Agency risk against loss, as required by regulations. OIG was critical of the Agency's follow-up attempts with the lender to obtain the required financial statements and the lender analysis. The audit states that, in some cases, the Agency is not conducting a review of the financial information submitted by the lenders. The audit further states that the Rural Business-Cooperative Service was not aware of the extent of nondelinquent problem loans nationally, because of under-reporting in the Rural Community Facilities Tracking System (RCFTS). As a result, OIG believes that, potentially, our B&I delinquencies and losses are much greater than currently reported.

This Administrative Notice (AN) is to provide guidance to lenders and State Office personnel on the minimum spread requirement and financial analysis standards that the lenders must perform to comply with RD Instruction 4287-B, section 4287.107(d), and Form RD 4279-4, "Lender's Agreement," paragraphs IV., C., 6., and 11. The Agency is also emphasizing the need and requirement for State Offices to maintain and track the servicing activity of nondelinquent problem loans in RCFTS. This guidance is also applicable to meeting the requirement contained in RD Instruction 4279-B, section 4279.161(b)(8).

EXPIRATION DATE:
September 30, 2001

FILING INSTRUCTIONS:
Preceding RD Instruction 4287-B

The State Offices are requested to notify all lenders that failure to obtain or analyze financial statements or to properly service loans could be considered negligent servicing and that the Loan Note Guarantee may be rendered unenforceable.

COMPARISON WITH PREVIOUS AN:

This AN replaced RD AN No. 3467, dated May 14, 1999, which expired on May 31, 2000.

IMPLEMENTATION RESPONSIBILITIES:

The lender is responsible for obtaining and forwarding to the Agency the financial statements required by the Loan Agreement. The lender is responsible for providing the Agency with (1) an analysis of the borrower financial statements (including spreadsheets), (2) a written trend analysis that compares borrower year-to-year historical financial information, and (3) a borrower ratio comparison to industry standards for similar size businesses. The lender's written analysis to the Agency should include the borrower's strengths, weaknesses, extraordinary transactions, term loan agreement violations, and other indications of the financial condition of the borrower. The lender will submit the annual financial statements to the Agency, along with its spreadsheets and written analysis, within 120 days of the end of the borrower's fiscal year.

At a minimum, the lender is required to prepare the ratios identified on the attachment and provide those ratios to the Agency, along with its written summary of the analysis. Promptly obtaining and reviewing financial information from the borrower can reveal financial red flags that indicate problems the borrower may be experiencing and has not disclosed. These indicators provide guidance for adequately servicing the loan. A review of the financial statements assists the lender and State Office in determining the appropriate action that will maximize recovery to the Agency. It is important to note that every borrower is different, economic conditions change, industry conditions are not constant, and public policy and community relations affect how lenders deal with problem loans.

The State Office must inform lenders, in writing, that failure to obtain the required financial statements or to document efforts to obtain financial statements could result in the loan guarantee being unenforceable due to negligent servicing. The lender servicing responsibilities under the loan agreement are contained in Form RD 4279-4, "Lender's Agreement," paragraph IV. The lender's servicing responsibilities include, but are not limited to, obtaining compliance with the loan covenants and getting borrower periodic financial statements, as required by the loan agreement.

We must improve in our efforts to obtain financial statements, review the lender's analysis, and provide follow-up up to lenders on servicing deficiencies. Our files should be documented to show our attempts to obtain the required information.

In addition, the State Office should place increased emphasis on maintaining RCFTS in a current status on all B&I loans, which includes reporting all nondelinquent problem loans into RCFTS. The B&I Guaranteed Loan Program is growing, and it is important that the Agency properly monitor the guaranteed lenders to minimize potential losses to the Government. The National Office has implemented, as part of its Business Programs Assessment Reviews, an observation and comparison of the nondelinquent problem loans serviced by the State Office and the numbers reported in RCFTS. Periodically, you may also be asked to submit your RCFTS reports of nondelinquent problem loans to the National Office for spot reviews.

If you have any questions, please contact David W. Lewis, Senior Loan Specialist, Business Programs Servicing Division, 202-690-0797.

(Signed by Randall E. Torgerson)   for

WILBUR T. PEER
Acting Administrator
Rural Business-Cooperative Service

Attachment

Attachment

FINANCIAL STATEMENT ANALYSIS

At a minimum, the lender's financial analysis should include but is not limited to the following:

1. **Current Ratio**: Measures the ability of a company to pay its currently maturing obligations on a timely basis. It shows the amount of protection provided by a company's current assets relative to its current liabilities.

   $$\frac{\text{Total current assets}}{\text{Total current liabilities}}$$

2. **Quick Ratio**: Expresses the degree to which current liabilities of a company are covered by the most liquid current assets. This acid test ratio is a more stringent measure of liquidity than the current ratio, because the quick ratio includes only the most liquid current assets or those that can be quickly converted to cash at amounts close to their book value.

   $$\frac{\text{Cash + Accounts receivable (trade) + Marketable securities}}{\text{Total current liabilities}}$$

3. **Days Accounts Receivable Ratio**: Expresses the average time in days that receivables are outstanding. The collection period varies greatly for different types of companies, and it is important to make comparisons with similar companies or to look at trends over time.

   $$\frac{365}{\text{Net sales/Accounts receivable}}$$

4. **Days Inventory Ratio**: Measures the company purchasing, selling, and manufacturing efficiency but is meaningful only in relation to the company's past performance and to the performance of similar companies in the same industry.

   $$\frac{365}{\text{Cost of goods sold/Inventory}}$$

5. **Debt-to-Worth Ratio**: Provides an indication of how well the investment of the shareholder in the company protects a creditor debt. It also measures how much the shareholders have at risk versus how much the creditors have at risk and, thus, the strength of the company capital structure.

   $$\frac{\text{Total liabilities}}{\text{Tangible Net worth}}$$

6. **Times-Interest-Earned Ratio**: Measures what proportion of the company earnings is needed to pay interest on its debt. A ratio of 1 is almost mandatory, since a lower ratio would indicate company earnings are insufficient to cover the interest on its debt.

$$\frac{\text{Earnings before taxes + Interest expense}}{\text{Interest expense}}$$

7. **Debt Service Coverage Ratio**: Measures the proportion of a company net profit and noncash expenses that will be needed to pay the principal portion of long-term debt in the coming year.

$$\frac{\text{Net profit + Depreciation + Other non-cash charges}}{\text{Current maturities of long-term debt}}$$

8. **Return-On-Sales Ratio (or Net Profit Margin)**: Measures the extent to which revenues of a company exceed all its expenses, that is, how much profit the company earns on each dollar of sales.

$$\frac{\text{Profits before taxes}}{\text{Net sales}}$$

9. **Return-on-Assets**: Measures the profitability of a company in terms of how efficiently it uses its assets.

$$\frac{\text{Profit before taxes}}{\text{Total assets}}$$

10. **Return-on-Equity Ratio**: A high return, normally associated with effective management, could indicate an under-capitalized firm. A low return, usually an indicator of inefficient management performance, could reflect a highly capitalized, conservatively operated business.

$$\frac{\text{Profit before taxes}}{\text{Tangible net worth}}$$